

Internal Revenue Service

memorandum

CC:TL-N-9740-90

Br2:JMSchwartzman

date: JAN - 8 1991

to: Acting District Counsel, Dallas CC:DAL
Attn: S. W. Brower

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED] -Like-Kind Exchanges

This responds to your request for advice on whether the taxpayer's transactions described below qualify for gain deferral as like-kind exchanges under I.R.C. § 1031. We conclude that these transactions do not qualify as like-kind exchanges and, therefore, we recommend that a Notice of Deficiency be issued to the taxpayer.

ISSUE

Whether the transactions described below qualify for nonrecognition treatment under section 1031 as like-kind exchanges where the taxpayer exchanges his property for interest bearing "Exchange Equity" which the exchanger received in cash sales of the properties to unrelated third parties and holds in trust for the taxpayer until the taxpayer directs it to purchase exchange property.

RECOMMENDATION

We recommend that you issue a Notice of Deficiency to [REDACTED] challenging these transactions on the following grounds: (1) The partnerships, not [REDACTED], made the sales; these transactions constituted sales, not exchanges, because the partnerships received cash and not like-kind property. As a result, [REDACTED] recognized income from his distributive share of partnership proceeds under sections 61(a)(13), 701 and 702. (2) Even if the partners made the transfers, [REDACTED] received cash, not like-kind property, under the three doctrines of substance over form, step transaction and constructive receipt. (3) [REDACTED] did not hold the properties exchanged or the properties received for use in a trade or business or for investment. (4) To the extent that [REDACTED] started with a partnership interest and ended with a partnership interest the transactions are specifically excepted from section 1031 treatment.

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FACTS

The Examiner determined deficiencies in taxpayer's income tax for the years [REDACTED] and [REDACTED] in the amounts of \$[REDACTED] and \$[REDACTED] respectively. These amounts reflect the gain on taxpayer's disposition of real property as follows.

[REDACTED]

Amount Realized	\$ [REDACTED]
Basis	[REDACTED]
Capital Gain	\$ [REDACTED]
40% (§ 1202) ¹	\$ [REDACTED]

[REDACTED]

Amount Realized	\$ [REDACTED]
Basis	[REDACTED]
Capital Gain (short-term)	\$ [REDACTED] ²

[REDACTED]

Amount Realized	\$ [REDACTED]
Basis	[REDACTED]
Capital Gain	\$ [REDACTED]
40% (§ 1202)	\$ [REDACTED]

The taxpayer, [REDACTED], entered into [REDACTED] separate real estate transactions with property owned by [REDACTED] joint ventures and a partnership.³ Taxpayer claims that the transactions qualified as section 1031 tax-free exchanges, relying on the related cases Starker v. United States, 79-2 USTC ¶ 9541 and Bruce Starker v. United States, 75-1 USTC ¶ 9443. We examine the facts of each transaction in turn.

¹ Prior to the Tax Reform Act of 1986, section 1202 of the Code provided that if, "for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income." This provision effectively reduced the taxable portion of a net capital gain to 40 percent of the net capital gain.

² In discussions with the taxpayer, Appeals allowed [REDACTED] an ordinary loss of \$[REDACTED] in "[REDACTED]," thereby reducing their basis by that amount, increasing the capital gain to \$[REDACTED].

³ Joint ventures are partnerships for tax purposes and, therefore, will be referred to as such in this memorandum. See section 7701(a)(2).

1. [REDACTED]

Interests in the [REDACTED]
[REDACTED] were held as follows:

Owner	Interest
[REDACTED]	[REDACTED] %
[REDACTED]	[REDACTED] %
[REDACTED]	[REDACTED] %

On [REDACTED], [REDACTED] ([REDACTED]), the managing general partner of [REDACTED] and acting as trustee for the partnership, entered into a contract for the sale of [REDACTED]'s property with an unrelated third party, [REDACTED] ([REDACTED]). [REDACTED] managed the [REDACTED]'s property on a day-to-day basis. On [REDACTED], [REDACTED] deeded the real estate owned by [REDACTED] to its partners in accordance with their respective interests in the joint venture. Under sections 731(a) and (b), neither the partners nor the partnerships recognized gain on this distribution. [REDACTED]'s basis in his distributive share of the property in liquidation was the same as his basis in the partnership. Section 732(b).

On the same day, [REDACTED] and the [REDACTED] individual partners entered into a Real Estate Exchange Agreement with [REDACTED]. According to that agreement, [REDACTED] and the [REDACTED] individuals conveyed to [REDACTED] their interests in the [REDACTED] property solely in exchange for property qualifying as like-kind property pursuant to section 1031 of the Code. [REDACTED]'s equity in the property transferred to [REDACTED] was \$[REDACTED].

On [REDACTED], [REDACTED] and [REDACTED] conveyed to [REDACTED] the [REDACTED] property for \$[REDACTED] cash. Although that contract of sale provided that the purchaser would cooperate with the seller to accomplish a like-kind exchange, it also provided that the sale would be for cash if the seller did not designate exchange property by the closing date or if purchaser was unable to acquire the exchange property designated by the seller.

[REDACTED]'s portion of the proceeds, recorded as "Exchange Equity" on [REDACTED]'s books, was \$[REDACTED]. That amount was identified as "Starker Funds" on [REDACTED]'s books. [REDACTED] was paid the \$[REDACTED] rate of interest on those funds until he received property equal in value to that amount. [REDACTED] reported that interest as income on his returns. In exchange for the Starker funds, [REDACTED] received interests in [REDACTED] partnerships as follows:

⁴ It appears that [REDACTED] sold its interest in the property and, therefore, should have recognized gain on the transaction.

<u>Date Received</u>	<u>Partnership Interest</u>	<u>Value</u>
		\$
		\$

Importantly, the Real Estate Exchange Agreement entered into by [REDACTED] and [REDACTED] provided that [REDACTED] was liable to [REDACTED] in the amount of his remaining Exchange Equity as liquidated damages if [REDACTED] failed to convey suitable exchange property within [REDACTED] months of the exchange agreement.

2. _____

On [REDACTED], [REDACTED], again acting as trustee for the partnership, entered into a contract for the sale of the [REDACTED] [REDACTED] ([REDACTED]) property to [REDACTED], an unrelated third party. The terms of the contract provided for a cash payment of \$ [REDACTED] at the [REDACTED] closing. The contract also provided that the purchaser would cooperate with the seller to effect a like-kind exchange. If the seller failed to designate exchange property by the date of the closing or if the purchaser was unable to purchase the exchange property, then the sale was to go through for cash.

On [REDACTED], [REDACTED], as trustee for [REDACTED], deeded [REDACTED] interests in that partnership to itself, as a partner, and to [REDACTED], the other [REDACTED] partner of [REDACTED].⁵ On the same day, [REDACTED] executed a Real Estate Exchange Agreement with [REDACTED]. According to that agreement, [REDACTED] conveyed his [REDACTED] interest in the [REDACTED] property to [REDACTED] and [REDACTED] would later convey like-kind property to [REDACTED]. As in the [REDACTED] Real Estate Exchange Agreement, any amount not used to purchase like-kind property would be owed to [REDACTED] as liquidated damages.

██████████'s "Exchange Equity" in the \$██████████ proceeds was \$██████████. That amount was held by ██████████ in ██████████'s name as Exchange Equity and was listed on ██████████'s books as "Starker Funds." ██████████ received interest at the \$██████████ ██████████ rate and reported those amounts as income on his tax returns. ██████████ had a basis of \$██████████ in those funds.

Part of those funds were used to purchase two ranches, one tract of land and interest in three partnerships as follows:

⁵ It is unclear from the RAR and Appeals report whether [REDACTED] was the other [REDACTED] owner of the [REDACTED] property or whether the other owner was [REDACTED], of which [REDACTED] was a partner.

amount of the [REDACTED] Exchange Equity.

LAW

Section 61(a) provides that income means all income from whatever source derived, including gains from dealings in property. Section 61(a)(3). The entire amount of gain or loss on the sale or exchange of property shall be recognized, except as otherwise provided. Section 1001(c). An exception is provided in section 1031, which excepts exchanges of like-kind property from immediate gain or loss recognition. Specifically, no gain or loss is recognized on the exchange of property held for either investment or the productive use in a trade or business solely for property of like kind which is also so held.

The Service's position is that when property is received with the intention of immediately transferring the property, like-kind exchange treatment is not available because the property received is not held for use in a trade or business or for investment. Click v. Commissioner, 78 T.C. 225 (1982) (Exchange did not qualify for like-kind treatment because the taxpayer did not intend to hold the properties received for use in a trade or business or for investment, but rather to make gifts of the properties to her children); Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-297, 1977-2 C.B. 304; Rev. Rul. 77-337, 1977-2 C.B. 305; Cf. Wagensen v. Commissioner, 74 T.C. 653 (1980) (Like-kind exchange treatment accorded where taxpayer had intended to make a future gift of the property received in the exchange); Magneson v. Commissioner, 81 T.C. 767, aff'd, 753 F.2d 1490 (9th Cir. 1985); Bolker v. Commissioner, 81 T.C. 782, aff'd, 760 F.2d 1039 (9th Cir. 1985); Maloney v. Commissioner, 93 T.C. 89 (1989).

In Magneson, the taxpayer exchanged a fee interest in one piece of real estate for a fee interest in another. On the same day, he contributed the fee interest received in the exchange to a limited partnership in return for a general partnership interest.

The court held that section 1031 does not require the taxpayer to hold the acquired property by the exact form of ownership in which it was acquired as long as the taxpayer continues to hold the property for investment if the change in the form of ownership does not significantly affect the amount of control or the nature of the underlying investment. In addition, the court rejected the Service's alternative argument that, applying the step transaction, the taxpayer exchanged a fee interest in real property for a general partnership interest, which is not like-kind property. Its rejection was based on the fact that the transaction could not have been achieved more directly in a taxable transaction and that, even if it could, it would be improper to apply the step transaction doctrine because the rights of a fee owner and a general partner to manage and control property are very similar. Thus, the court

held, the taxpayer did not lose any control by virtue of his contribution of the property received in the exchange for a general partnership interest.

Critical to the court's holding was the fact that the partnership's underlying assets were of like-kind to the taxpayer's original property and were held for investment.

In Bolker, the taxpayer was the sole shareholder of the Crosby Corporation (Crosby), which owned the Montebello property. The taxpayer liquidated Crosby and distributed the property to himself. Due to financing difficulties, he decided to dispose of the property instead of developing it. On the day of Crosby's liquidation, the taxpayer contracted to exchange the property for like-kind property. The actual exchange took place three months later.

The court, relying in part on Magneson, concluded that a taxpayer holds property for the use in a trade or business or for investment if he owns property which he does not intend to liquidate or to use for personal purposes. Thus, the court held, Bolker's receipt of the Montebello property with the intent to exchange it for like-kind property satisfied the holding for permitted purpose requirement. As a result, the transaction qualified for section 1031 like-kind exchange treatment.

In Maloney, the petitioner owned all of the stock of Van, a Louisiana corporation that had been engaged in moving and storing furniture, but after 1977, only leased its assets to related corporations. One of Van's primary assets was the I-10 property in New Orleans. On August 2, 1978, Van entered into an exchange agreement according to which it exchanged the I-10 property for the Elysian Fields property. That exchange took place on December 28, 1978. On January 26, 1979, Van liquidated and its assets were distributed to the petitioner. He then leased Elysian Fields to a related corporation for 25 to 30 years. At the time Van entered into the exchange agreement, it was intended that Van liquidate and distribute Elysian Fields to petitioner to hold for investment.

The court, relying on Magneson and Bolker, concluded that Van's purpose was petitioner's purpose and that the acquired property, Elysian Fields, was not "cashed out." Thus, the court held, the exchange reflected continuity of ownership and continuity of investment intent. If Van had not liquidated and continued to hold Elysian Fields as petitioner did, the exchange would have qualified under section 1031. The court held that the mere addition of another nontaxable transaction (under section 721 or 333) does not per se destroy the nontaxable status of the transaction under section 1031.

Treas. Reg. § 1.1002-1(b) provides:

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule.

In short, an exchange must satisfy the form and the substance of the requirements to qualify for nonrecognition treatment under section 1031. The regulations further provide that, "ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only." Treas. Reg. § 1.1002-1(d). The courts, nonetheless, have allowed taxpayers wide latitude in structuring qualifying transactions. Swaim v. United States, 651 F.2d 1066 (5th Cir. 1981); Biggs v. Commissioner, 69 T.C. 905, aff'd, 632 F.2d 1171 (5th Cir. 1980).

Multi-party transactions can be used to effect a valid like-kind exchange. Rev. Rul. 77-297, 1977-2 C.B. 304. A multi-party exchange involves more than two parties and two or more properties. In such transactions, the exchanger need not acquire legal title to the property to qualify for section 1031 nonrecognition. Biggs; Rev. Rul. 90-34, 1990-1 C.B. 341. In addition, like-kind exchanges need not be simultaneous. Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).⁸ Moreover, the taxpayers can locate the exchange property, negotiate for the purchase of that property and even advance money towards the purchase of the exchange property. Biggs; Starker. Taxpayers can even receive interest or "growth factors" on amounts being held towards the purchase of exchange property. Starker. The taxpayer's intent to effect a like-kind exchange, however, is not dispositive. Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).

⁸ TRA '84 and the Tax Reform Act of 1986 amended section 1031 of the Code to provide that, in order to qualify for like-kind exchange treatment, the exchange property must be identified within 45 days of the transfer of the property relinquished in the exchange and the exchange property must be received within 180 days of that transfer. These amendments apply to exchanges made after July 18, 1984. Exchanges, like those at issue here, made on or before that date will qualify under section 1031 as long as the exchange property is received prior to January 1, 1987 and provided that the other requirements of that section have been met.

Assessing these transactions under section 1031 is often a troublesome task:

The 'exchange' requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the substance of a transaction in which the taxpayer sells property and immediately reinvests the proceeds in like-kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash. Bell Lines, Inc. v. United States, 480 F.2d 711 (4th Cir. 1973). Yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must, at least, on occasion, engender different results. Accord, Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979)."

Swaim v. United States, 651 F.2d 1066, 1070 (5th Cir. 1981) (quoting Barker v. Commissioner, 74 T.C. 555 (1980)).

Courts have focused on two main points: 1) whether the formalistic requirements of section 1031 have been met and 2) whether, at any point in the transaction, the taxpayer's investment has been reduced to cash.⁹ Three judicial doctrines have developed to assist in the assessment of these transactions: substance over form, the step transaction and constructive receipt.

Substance Over Form Doctrine

The inquiry of the substance over form doctrine applied to multi-party like-kind exchanges is who made the sale. Cf. Commissioner v. Court Holding Company, 324 U.S. 331 (1945). This doctrine applies "where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." Chase v. Commissioner, 92 T.C. 874, 881 (1989). In Chase, petitioner owned a 46% interest in a limited partnership which owned an apartment building. The partnership ran the apartment building, collected the rents and paid all expenses associated with the building. The partnership negotiated the sale of the building. Petitioner did not participate in those negotiations. Before the

⁹ Green: If the property is reduced to cash and there is a gain, of course it will be taxed.

La Guardia: Suppose that cash is immediately put back into the property, into the business?

Green: That would not make a difference.

65 Cong. Rec. 2799 (1924).

closing date of the sale, petitioner entered into a Real Property Trust Exchange Agreement with the exchanger. That Agreement provided that the exchanger would transfer petitioner's share of the proceeds received from the sale of the property to an unrelated third party to a trust. The trust, in turn, would transfer to petitioner like-kind property.

The Tax Court found that the partnership and not petitioner sold the apartment building. In addition, it found that the partnership was not acting as petitioner's agent in connection with the sale. It held, therefore, that petitioner failed to exchange like-kind property because, in substance, the partnership was the seller of the property and it did not receive like-kind property in the "exchange." Court Holding Company.

Step Transaction Doctrine

The step transaction doctrine has been used to determine whether a series of events constitute separate taxable transactions or mere steps in one integrated transaction. The standard used in making that determination is whether the steps were mutually interdependent. That is, if the receipt of like-kind property is not mutually or contractually interdependent on the transfer of property, there can be no like-kind exchange. In essence, the ultimate question here is whether the taxpayer had the unrestricted control of cash or other nonlike-kind property prior to the receipt of like-kind property. Although the Service has rarely prevailed in cases in which it attempted to disqualify like-kind exchanges on the basis that the receipt of property was dependent on the transfer of like-kind property, the courts have recognized its applicability. J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963) (holding that each step was part of an integrated whole, stating that a transaction must be viewed as a whole); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963) (stating that a transaction should not be separated into its component parts for tax purposes).

In Carlton v. United States, 385 F.2d 238 (5th Cir. 1967), however, the step transaction was applied to preclude like-kind exchange treatment to a transaction. There, the parties entered into a like-kind exchange agreement. Instead of transferring like-kind property, one party assigned his right to purchase other property, plus the cash to purchase that property. The court held that the transaction constituted a sale because the taxpayer had an unrestricted right to the cash. Noting that the step transaction requires an analysis of each step in the transaction, the court stated that, although the entire transaction must be viewed as a whole, each step must meet the formal requirements of section 1031. In this instance, the court found that the taxpayer did not comply with the requirements of section 1031 because he

received cash, though the transaction as whole appeared to comply with that section. In noting the rule that a transaction must be viewed as a whole, the court stated, "that rule does not permit us to close our eyes to the realities of the transaction and merely look at the beginning and end of a transaction without observing the steps taken to reach that end."

Constructive Receipt Doctrine

The constructive receipt doctrine applies an objective standard in determining whether a transaction fits within the continuity of investment rationale underlying section 1031. If the taxpayer receives the sale proceeds, either actually or constructively, gain or loss should be recognized, even if that cash is immediately reinvested in like-kind property.

In Halpern v. United States, 286 F. Supp. 255 (ND GA 1968), the taxpayer, Halpern, entered into a like-kind exchange agreement with Chennault according to which Halpern was to receive like-kind property, as well as substantial boot. Since Halpern wished to purchase like-kind property with the boot, he instructed Chennault to place the boot in an escrow account. Halpern then negotiated for the purchase of additional properties. On the closing date, Chennault transferred the boot to the escrow account and Halpern closed his other purchases with the escrow funds.

The district court upheld the Commissioner's determination that the taxpayer purchased the additional properties with the proceeds of the Chennault exchange. The court based its holding on the fact that the purchase of the additional property was not integral to the Halpern-Chennault exchange. The court noted that 1) Chennault never took title to the other property, 2) Halpern negotiated the purchase of the other properties and 3) there was no contractual interdependence between the various transactions. Thus, the court found, that Halpern constructively received the exchanger's cash because he had unfettered control over the escrowed funds and could have received the cash by simply refusing to take title to the property being purchased. Although not taking title to the exchange property and negotiating the purchase by the exchanger are no longer considered violative, contractual or mutual interdependence between the transactions is still arguably a requirement for like-kind exchange treatment.

In Maxwell v. United States, 88-2 U.S.T.C. ¶ 9560 (S.D. Fla. 1988), the taxpayer transferred property to an exchanger and the exchanger transferred cash to an escrow account. Only the taxpayer had the right to terminate the escrow prior to the purchase of exchange property. In any event, the escrow terminated after one year.

The court declined to hold that the transaction qualified for

like-kind exchange treatment, stating that the, "seller, in the case at bar, had by virtue of the escrow agreement, unbridled discretion to terminate the escrow prior to the use thereof for purchasing the 'contemplated' real property." The court emphasized that it was not persuaded by plaintiff's argument that, "the lawyer H. Gordon Brown 'would not permit the Beneficiaries of the Trust No. 665 to obtain any of the escrowed proceeds for any reason other than obtaining exchange properties unless the tax purposes of the transactions were totally frustrated.'"

The agency concept plays a significant role in the application of both the substance over form and constructive receipt doctrines. Recall, the ultimate question is whether the taxpayer had unrestricted control of cash or other nonlike-kind property prior to the receipt of like-kind property. Agency is the relationship which results when one party manifests his intent that another party act on his behalf, subject to his control and with his consent. Restatement (Second) of Agency § 1 (1958). This concept applies to determine whether there has been a like-kind exchange in form. Applied to the constructive receipt doctrine, the inquiry is whether the taxpayer, through his agent, has received the exchange partner's cash at some point in the transaction. Applied to the substance over form doctrine, the inquiry is who sold the exchange property. If the taxpayer sold it either directly, or indirectly through his agent, no exchange has occurred.

In Halpern, the court found that the taxpayer constructively received the exchanger's cash because the funds were held by the title insurance company as a "mere temporary depository" and the taxpayer had unfettered control over the money. By refusing to accept title to the property being purchased, Halpern could have received the cash. Although the court did not specifically apply the agency theory in this case, it clearly applies on those facts. Halpern actually received the exchanger's cash through his agent, the title insurance company.

In Coupe v. Commissioner, 52 T.C. 394 (1969), petitioners entered into a contract for a sale of their property to an unrelated third party. After being informed of the tax advantages of a like-kind exchange, petitioners desired to effectuate an exchange. When the purchaser refused, petitioners' attorney purchased exchange property in his own name and exchanged it for petitioners' property, which he sold to the unrelated third party.

The Tax Court held that petitioners' transaction qualified for like-kind treatment. The court agreed that the exchange would be meaningless if petitioners' attorney had acted as their agent. It found, however, that there was no intention to create an agency relationship and that the attorney was acting as the third party purchaser's de facto agent. The court's finding was based on the fact that the corporate purchaser agreed to have the attorney act as its agent to purchase and convey exchange property to

petitioners and to sell petitioners' property to it.

The Service's position is to challenge section 1031 treatment where the taxpayer exchanges a partnership interest for another partnership interest in pre-1984 transactions. Rev. Rul. 78-135, 1978-1 C.B. 256. Contra Long v. Commissioner, 77 T.C. 1045 (1981) (Like-kind treatment afforded to the exchange of general partnerships where the underlying assets of the partnerships were substantially the same.); Pappas v. Commissioner, 78 T.C. 1078 (1982) ("It is well established that, in general, an exchange of general partnership interests is an exchange of property of like kind, but that an exchange of a general partnership interest for a limited partnership interest is not an exchange of property of like kind."). Specifically, the Service recommends challenging like-kind treatment (1) where there is an exchange of general partnership interests if the underlying assets are not like-kind, (2) where there is an exchange of general partnership interests if the exchange is a ploy designed to circumvent section 1031 and (3) where there is an exchange of a limited partnership interest, regardless of the form or substance of the transaction.

ANALYSIS

Under the substance over form doctrine, these transactions were not reciprocal exchanges of property by [REDACTED], but rather the sale of property by the partnerships, followed by reinvestment of the proceeds in other property. As in Chase, [REDACTED] sold the properties on behalf of the partnerships. That is, [REDACTED] was not the seller and, therefore, the purported exchanges between [REDACTED] and [REDACTED] were of no tax consequence. This is clear from the fact that [REDACTED] entered into the contracts for the sale of the [REDACTED] and the [REDACTED] properties as trustee for those partnerships and, thus, bound the partnerships and thereby its partners. Under the exchange agreements, [REDACTED] was specifically held harmless: "It is intended that the foregoing be accomplished at no cost or expense to [REDACTED] and the undersigned hereby agree to indemnify and hold [REDACTED] harmless of and from all costs, claims, demands, damages and causes of action of every type suffered by [REDACTED] as a result of complying with the provisions of this letter." It is also clear that [REDACTED] sold the properties on behalf of the partnerships in that [REDACTED] did not receive compensation for its efforts in selling those properties and that [REDACTED] did not recognize any gain on the sales. But see Coupe (Tax Court found petitioners' attorney not to be their agent because they agreed that he would not be and because the attorney had personal liability under the purchase and exchange agreements). Here, [REDACTED] consented to act as the partnerships' agent and had no personal liability under the sale or exchange agreements. [REDACTED] held itself out to the third party purchasers as trustee for the partnership, [REDACTED] did not become liable for the transfer and did not receive the proceeds in its own right. It merely held the sale proceeds as trustee. In his letters to [REDACTED]

instructing it to purchase exchange property, ██████ stated, "[a]t the present time, ██████ (██████) is holding as trustee certain funds in which the undersigned has a beneficial right." Because ██████ personally entered into the contract of sale for the ██████ property, the substance over form doctrine may not apply to deny like-kind treatment, as courts consider who negotiated the sale in determining who made the sale. Hence, the fact that ██████ conveyed that property as trustee for the partnership may not control.

Under both the step transaction doctrine and the constructive receipt doctrine, ██████'s transactions fail to qualify for like-kind exchange treatment. Like the taxpayer in Carlton, ██████ had an unfettered right to the cash proceeds from the sales by ██████.¹⁰ By not designating any like-kind properties, the cash would have been distributed to ██████ as "liquidated damages." Furthermore, because of the close nature of the relationship between ██████ and ██████, it appears that ██████ would have been obligated to give the Exchange Equity funds to ██████ at any time if he had asked. In other words, because of the close relationship between ██████ and ██████, any provisions which might appear to preclude the taxpayer from immediate and complete control of the proceeds from the sales should be ignored. Like the transaction in Halpern, there was no contractual or mutual interdependence between the sale of the various properties and the purchases of other properties. Even if ██████ had never found any exchange properties, the sales of the properties by ██████ to unrelated third parties remained unaffected. Like the taxpayer in Maxwell, ██████ had unbridled control over the Exchange Equity. If ██████ had asked for the funds, ██████ could certainly not have refused him.

Just as clear, is the fact that ██████ was acting as the partnerships' agent in connection with the sales. Since ██████ was acting as the partnerships' agent, and since receipt by an agent is receipt by the principal, the partnerships did not receive like-kind property in exchange for their property. They received cash. Hence, ██████ effectively received his distributive share of the partnerships' proceeds from the sale under section 702(a). In addition, ██████ did not profit from the sales of the properties, thus exhibiting a lack of intent to act on its own behalf. Moreover, ██████ specifically held itself out to the unrelated third-party purchasers as the agent-trustee of the various partnerships. As noted above, ██████ also held the proceeds as trustee for ██████, and thus giving him, in fact, unfettered control over those funds. Although a fiduciary may take a position adverse to its beneficiary

¹⁰ An interesting, though untested argument is that ██████ had control over the sales proceeds under the economic benefit theory by virtue of his right to currently receive the income (interest) from those funds. Thus, these transactions would constitute cash sales.

if there is full disclosure and the beneficiary consents, no such adverse position was taken by [REDACTED] in respect of [REDACTED]. But see Coupe.

The examining agent noted that many of the properties acquired by [REDACTED] with his Exchange Equity were not held by him for use in a trade or business or for investment. The agent stated that [REDACTED] purchased the [REDACTED] property specifically to donate it to the [REDACTED]. To the extent that you develop facts indicating that [REDACTED] did not intend to hold the property received for use in a trade or business or for investment, it may be argued that like-kind exchange treatment is precluded.

Along these lines, another argument can be made that [REDACTED] did not transfer property which was held for use in a trade or business or for investment. Specifically, when the properties were distributed from the partnerships, [REDACTED] held them with the intent to exchange the properties with [REDACTED], not to hold them for a permitted purpose. Though it is Service's position that such transfers do not qualify for section 1031 treatment, this position involves substantial litigation hazards in light of the Magneson, Bolker and Maloney decisions. We note that Magneson and Bolker are Ninth Circuit cases, however, and, if litigated to appeal, [REDACTED]'s case would be in the Fifth Circuit. In light of the litigation hazards associated with this position, we leave it to your discretion whether or not to raise it in the Notice of Deficiency.

Here, even if we do not dispute that the properties originally held by [REDACTED] and the properties which he eventually received were held for investment, it may be argued that, in substance (via the step transaction doctrine), [REDACTED] effectively exchanged a portion of his partnership interests for other partnership interests. That is, in substance, to the extent that [REDACTED] began with a partnership interest and after the various transactions ended up with a partnership interest, it can be argued that he exchanged a partnership interest for a partnership interest, which are excepted from like-kind property treatment. This is the case when he started with a partnership interest, as he did in all cases, and ended with a partnership interest, as he did with respect to the [REDACTED] partnership interests purchased with the proceeds of the [REDACTED] property sale and the [REDACTED] partnership interests purchased with the proceeds of the [REDACTED] property sale.¹¹ Thus, to that extent, like-kind exchange treatment is not

¹¹ We note that the Tax Reform Act of 1984, which specifically excepted the exchange of partnership interests from section 1031 treatment, applies to transfers made after July 18, 1984. Since [REDACTED] of the [REDACTED] partnership interests [REDACTED] purchased with the proceeds of the [REDACTED] property and all [REDACTED] of the partnership

available because partnership interests are specifically excepted from such treatment as prohibited equity interests, chosen in action or evidences of indebtedness or interest. Rev. Rul. 78-135, 1978-1 C.B. 256. To date, however, the courts have not upheld that position. Nonetheless, it is still the Service's position to challenge transactions on that ground and, accordingly, we leave it to your discretion whether to raise this issue in the statutory notice, given the litigation hazards. Meyer Estate v. Commissioner, 58 T.C. 311, nonacq., 1975-1 C.B. 3, aff'd per curiam, 503 F.2d 556 (9th Cir. 1974) (exchange of partnership interests qualifies for section 1031 treatment where the underlying assets of the partnerships are the same); Gulf Stream Land and Development Corp. v. Commissioner, 71 T.C. 587 (1979) (focus is on the partnership interests, but the underlying assets should be scrutinized to ensure that section 1031 is not being abused)¹²; Magenson v. Commissioner, 753 F.2d 1490 (1985), aff'g 81 T.C. 767 (1983).

██████ contends that these transactions qualify for like-kind exchange treatment under the holdings in Starker. Starker, however, is distinguishable. There, the exchanger, an unrelated third party, kept an Exchange Value account in taxpayers' names. If taxpayers failed to identify exchange properties within five years, the exchange partner had the right to disperse the remaining Exchange Value to the them. In addition, the exchanger held the Starkers' property for investment or for productive use in its trade or business. Here, on the other hand, the exchanger was in no way an unrelated third party. Indeed, ██████ was, in effect, acting as ██████'s agent. Furthermore, the exchange agreements executed between ██████ and ██████ gave ██████ the right to the remaining Exchange Equity balance as liquidated damages, as opposed to ██████ having the right to disperse those funds to ██████.

CONCLUSION AND RECOMMENDATION

We conclude that these transactions were sales of property by the various partnerships and, therefore, do not qualify as like-kind exchanges by ██████ under section 1031. Thus, we recommend

interests purchased with the proceeds from the ██████ property were transferred to ██████ after July 18, 1984, they arguably fall within the specific exception to like-kind treatment for partnership interests. There is a question as to the applicability of this revision where ██████'s transfers were made prior to the revision. Even if the revision is not applicable to the transfers of the partnership interests to ██████, the Service's position is to challenge them under pre-'84 law.

¹² The Service finally prevailed on this issue in the Tax Reform Act of 1984. The transactions, here, however, are governed by pre-'84 law.

that a Notice of Deficiency be issued to the taxpayer setting forth deficiencies against [REDACTED] with respect to his share of the gain as a partner of the respective partnerships or, alternatively, as the seller of the properties involved.


To summarize, we recommend that you challenge these transactions on the basis that (1) the transactions constituted sales by the partnerships, not exchanges by [REDACTED], (2) the properties held by the taxpayer were not held for the productive use in a trade or business or for investment, (3) the properties exchanged by the taxpayer were not held for productive use in a trade or business or for investment and some of the properties received were not so held and (4) the properties in some cases were excepted from like-kind treatment.

These transactions constituted sales by the partnerships, not exchanges by the partners, because, in substance, the partnerships made the sales, not the partners and because [REDACTED] actually or constructively received cash sales proceeds through [REDACTED], which was acting as his or the partnerships' agent. In addition, it may be argued that [REDACTED] had unfettered control over the sales proceeds because there was no mutual or contractual interdependence between the sales of [REDACTED]'s properties and the purchases of "exchange" properties. Furthermore, it may be argued that [REDACTED] had unbridled control over the proceeds of the sales by virtue of his current right to the income (interest) from those funds.

The properties transferred by [REDACTED] were not held for a permitted purpose. If, as he claims, [REDACTED] exchanged the properties after receiving them in distributions from the partnerships, he clearly received those properties and, thus, held them, with the intent to sell or exchange them. As noted above, however, the case law (Magneson, Bolker and Maloney) presents a substantial litigating hazard to this position. Also, to the extent that the developed facts support, the properties received by [REDACTED] were not held for productive use in a trade or business or for investment. For example, the [REDACTED] property, which the taxpayer received with the express intent of donating to the [REDACTED] does not constitute property held for use in a trade or business or for investment. Moreover, it may be argued that like-kind properties were not exchanged where [REDACTED], in effect, exchanged interests in partnerships for other partnerships in an attempt to circumvent section 1031.

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